HEARING ON THE RECOMMENDATIONS OF THE STATE OF MICHIGAN'S INSURANCE CONSUMER ADVOCATE

Testimony as Delivered

by

Robert P. Hartwig, Ph.D., CPCU

President & Economist

Insurance Information Institute

New York, NY

Michigan House Insurance Committee

December 3, 2009

Lansing, MI

Thank you, Representative Byrum and members of the Committee.

Good morning. My name is Robert Hartwig and I am President and Economist for the Insurance Information Institute, a national property/casualty insurance trade association based in New York City.[1] I am also a Chartered Property Casualty Underwriter (CPCU) and have worked on a wide variety of insurance issues during my 16 years in the property/casualty insurance and reinsurance industries. In particular, my role as an economist has led me to devote considerable time and attention to various questions related to the functioning of insurance markets, including issues related to insurance industry profitability, risk and rate of return, competition, the critical role of underwriting criteria in ascertaining risk and the importance of actuarially sound, risk-based pricing. I have also spent significant time analyzing the impact of regulation on insurance markets—including both its benefits and potential distortionary effects on markets and competition. I have authored many reports on these issues and made hundreds of presentations before insurance, regulatory and legislative bodies.

In my testimony today I will address issues related to the relatively high cost of auto insurance in Michigan and what can be done to contain those costs. In the context of this discussion I will focus on the following issues:

(i) Competition and profitability in Michigan's property/casualty insurance markets and its private passenger auto insurance market in particular;
(ii) Michigan's unlimited no-fault benefit structure as a primary driver of cost; and
(iii) The inevitability of market distortions and subsidies associated certain proposed changes in permissible underwriting criteria and policy pricing.

Profitability in Michigan's Property/Casualty Insurance Markets

Profits are essential in maintaining healthy and competitive insurance markets and a financially strong and stable insurance industry. Insurance is the same as any other industry in this respect and Michigan's insurance markets are no exception.

---

[1] Contact information: Tel: (212) 346-5520; Email: bobh@iii.org.

Over the past decade, however, Michigan's property/casualty insurers have earned rates of return that are consistently *below* those of the insurance industry nationally. Moreover, profitability within Michigan's property/casualty insurance sector remains consistently below that of standard benchmarks such as the return on equity (ROE) for the Standard & Poor's or *Fortune* 500 group of companies. Profitability in Michigan's private passenger auto insurance market has been slimmer still, with rates of return below even what could be earned on a *risk free* investment in United States Treasury securities. These facts are documented in Figures 1 through 4.

Specifically, according to the National Association of Insurance Commissioners and as displayed in Figure 1, the average return on net worth (RNW) for all property/casualty insurance lines written in Michigan from 1998 through 2007 (the most recent decade for which data are available) was 7.2 percent compared to 7.6 percent for the US all lines RNW. In fact, profitability in Michigan's property/casualty insurance industry was below that of the US overall in 6 of the past 10 years. This clearly indicates that profits earned in insurers in Michigan cannot in any way be construed as excessive or unreasonable.

Figure 2 shows that between 1998 and 2007 Michigan's property/casualty insurance markets substantially underperformed relative to the *Fortune* 500 group of companies in all ten years. Indeed, the 7.2 percent return on net worth in the state's insurance markets was barely half that of the 13.6 percent ROE earned by the *Fortune* 500. This comparison provides incontrovertible proof that profits in Michigan's property/casualty insurance markets cannot by any standard be considered to be excessive or unreasonable.

Competitive Analysis: Michigan's Auto Insurance Market

Because there has been so much discussion on the cost of auto insurance in Michigan it is important to extend this analysis to the state's auto insurance markets. Even without examining rates of return earned by insurers, however, it is clear that Michigan is a state where it would effectively be impossible for any insurer to earn an "excessive" or "unreasonable" rate of return. More than 100 insurers are licensed to sell auto insurance in Michigan and they compete intensively to earn the business on more than 6.2 million vehicles throughout the state. Michigan's motorists are the clear beneficiaries of this competition and can choose from companies that operate on a national, regional or local scale. They can buy their insurance from any one of many thousands of agents. They can also buy direct online or over the telephone and can shop and compare prices with little more than a few clicks of a mouse. Indeed, Michigan's residents have many more options when it comes to buying automobile insurance than they do for automobiles themselves—an extraordinary fact in a state that is itself the capital of the US auto industry. The bottom line is that Michigan's auto insurance market is highly competitive, enabling consumers to choose among a large number of insurers—all at a time when it has never in history been easier for drivers to shop, compare and buy.

Profitability Analysis: Michigan's Auto Insurance Market

Competition is without question the greatest regulator of price and profit, and the preceding description of the competitive nature of Michigan's auto insurance industry would suggest that rates of return in the state's auto insurance market are highly unlikely to be excessive by any measure. Indeed, this turns out to be exactly the case. Figure 3 shows that the average rate of return in Michigan's private passenger auto insurance market was a mere 2.1 percent between 1998 and 2007—just one-fourth that of the US overall at 8.4 percent. This slim return is even more extraordinary considering that a *risk-free* investment in 10-year US Treasury notes over the same span of time would have provided a rate of return of 4.9 percent, as shown in Figure 4. It is obvious that an investment in the Michigan auto insurance market is anything but risk free.

The bottom line is that there exists no evidence, no proof and no standard by which profitability in Michigan's insurance markets, including its auto insurance market can be considered or judged to be excessive or unreasonable. It is therefore obvious that above-average auto insurance costs in Michigan are not the result of high profits, but of high costs in the system itself. Attacking the state's high cost structure is the only way to meaningfully reduce auto insurance premiums.

An Analysis of Costs Drivers in Michigan's Auto Insurance System

High costs, not a lack of competition, drive auto insurance prices in Michigan. The average policyholder in Michigan spent $928 in 2007 to insure their vehicle compared to $795 nationally, a difference of $133 or 16.7 percent (Figure 5). The state ranks as the eleventh most expensive in the country, up from eighteenth in 2001.

So what is driving Michigan's auto insurance costs up in both absolute and relative terms? While the cost drivers influencing the price of auto insurance in Michigan are similar to those in other states in most respects, there is one glaring exception—its unlimited threshold for no-fault auto insurance claims. No other state in the country provides unlimited no-fault benefits and for good reason—with unlimited benefits comes unlimited costs. Consider the following facts about costs:

- Between 1997 and 2007, prices as measured by the Consumer Price Index rose by 27 percent;
- Medical costs in Michigan rose by 51 percent
- The costs of the average No-Fault (PIP) claim rose by *250 percent* from $9,103 in 1998 to $31,883 in 2007.[2]

Worse is that the system operates with virtually no checks or balances. Consider that that in Michigan there are:

- No medical fee schedules (such as exist in most other states and in other lines of insurance like workers compensation);
- No utilization controls or treatment protocols, and;
- [Astonishingly] No state insurance fraud bureau to investigate and prosecute fraud and abuse in the system.

Given current trends in medical costs, Michigan's auto insurance costs are likely to continue grow indefinitely in absolute terms. Exacerbating this problem is the lack of

---

[2] Property Casualty Insurers Association of America *Fast Track* Monitoring data.

treatment protocols and fraud prosecution, which have given rise to a no-fault "fraud industry" in the state.

The inescapable conclusion: if nothing is done to contain runaway no-fault claim costs it is quite possible that someday Michigan will hold the dubious distinction of the state with the most expensive auto insurance in America. This is because Michigan's unlimited no-fault threshold exposes the state's drivers to the full force and fury of runaway healthcare costs. Quite literally, Michigan's no-fault system is the last and greatest blank check in the US healthcare system. As shown in Figure 6, medical costs have been rising at a much faster pace than overall inflation for 25 years with no end in sight. Nationally, extreme concern over rapidly rising healthcare costs and the affordability of medical care have sparked an intense public policy debate as well as federal legislation designed to reform the entire US healthcare system.

With medical fee schedules commonplace in other states other types of insurance and as the national debate on cost containment in the healthcare system in general continues to gather momentum, Michigan's unlimited benefit no-fault structure has clearly become an expensive anachronism. Under the status quo, no-fault claim costs will continue their inexorable upward climb. So what can be done?

Higher auto insurance premiums are not necessarily Michigan's manifest destiny. Swift, concrete actions that attack the root problem of costs can provide immediately relief. The implementation of medical fee schedules, treatment protocols and vigorous prosecution of fraud—all proven cost savers in other states—will go a long way in containing costs. In addition, giving consumers the choice of how much no-fault coverage they wish to purchase could significantly reduce system costs. If consumers were given the option of purchasing a still generous $50,000 benefit level (equivalent to New York's benefit—the highest dollar threshold in the country) the savings could be considerable.

Fixing Michigan's Problems Requires a Focus on the Root Problem: Costs

Michigan's relatively high auto insurance premiums derive from high costs originating in the state's anomalous unlimited no-fault benefit mandate, not from a lack of competition. Solutions that do not directly address this problem are destined to fail.

Restrictions and Bans on Underwriting Tools Will Not Lower Premiums in Michigan

Proposals to restrict or ban the use of certain underwriting and risk management tools currently used by insurers not only fail to address the root cause of high costs in Michigan, they are also certain to force millions of Michigan drivers to needlessly and unfairly pay hundreds of dollars more for their auto insurance. A proposed ban on the use of credit-based insurance scores illustrates this point. A typical family owning two cars and enjoying a 10 percent credit-related discount on their auto insurance would, on average, have to pay nearly $200 more annually for their coverage if such legislation is enacted. Worse, is the fact that their hard earned $200 would be taken from them and used to subsidize an individual who on average has a worse driving record. Because two-thirds of all policyholders benefit from a credit-related discount, the aggregate and ironic impact of a ban on the use of credit-based insurance scores would be to force Michigan's best drivers to pay hundreds of millions of dollars more for their insurance while the state's worst drivers would pay less. Every study ever done by state insurance departments, the Federal Trade Commission, the Federal Reserve and others (such as consulting firms) has demonstrated that insurance scoring is a proven, accurate, objective and consistent risk assessment tool. The data supporting its use are statistically irrefutable, and the benefits to consumers are significant. Critically, a ban on the use of credit-based insurance scores will do absolutely nothing to lower costs in Michigan and will instead create a system that is unfair to good drivers, forcing them to subsidize drivers who impose greater costs on the auto insurance system.

Price Controls and Subsidies Are Not Real Savings

Likewise, efforts to create low cost auto policies to improve affordability without also reducing the benefits provided are doomed to failure. Such programs implicitly require subsidies. Somebody has to pay for the still-high level of benefits. Experience in other states such as California have shown that such policies have little or no effect on the percentage of uninsured motorists on the road.

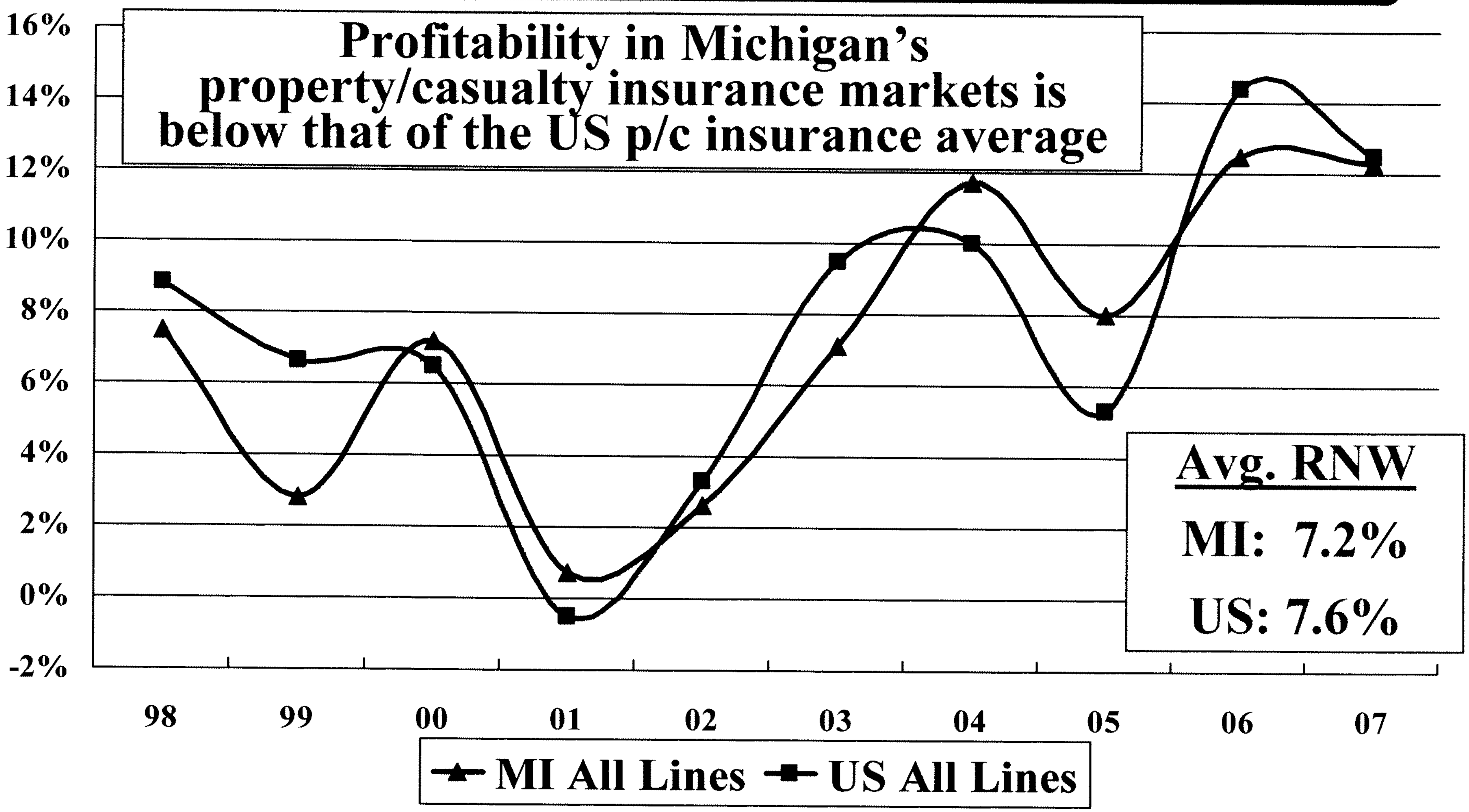
Summary

Michigan's insurance markets are competitive and rates of return earned by insurers are below those earned in other states, on average, or in other industries. By any standard, insurer profits in Michigan's insurance markets, including its auto insurance market, cannot be judged to be "excessive" or "unreasonable." With more than 100 companies offering auto insurance in the state, lack of competition is clearly not a contributing factor to Michigan's relatively high automobile insurance premiums. Solutions of what to do about the state's relatively high auto insurance premiums must necessarily focus on cost drivers. Michigan's one-of-kind, unlimited no-fault benefit level is the principal driver of system costs. Rising healthcare costs in the United States, coupled with an absence of controls on the price and type of treatments provided guarantee further price escalation under the status quo. Implementation of medical fee schedules and treatment protocols, vigorous prosecution of fraud and offering consumers choices regarding no-fault benefit levels would provide immediate benefits to every driver in Michigan.

Thank you for you for the opportunity to testify before the Committee today. I would be happy to respond to any questions you may have.

Figure 1.

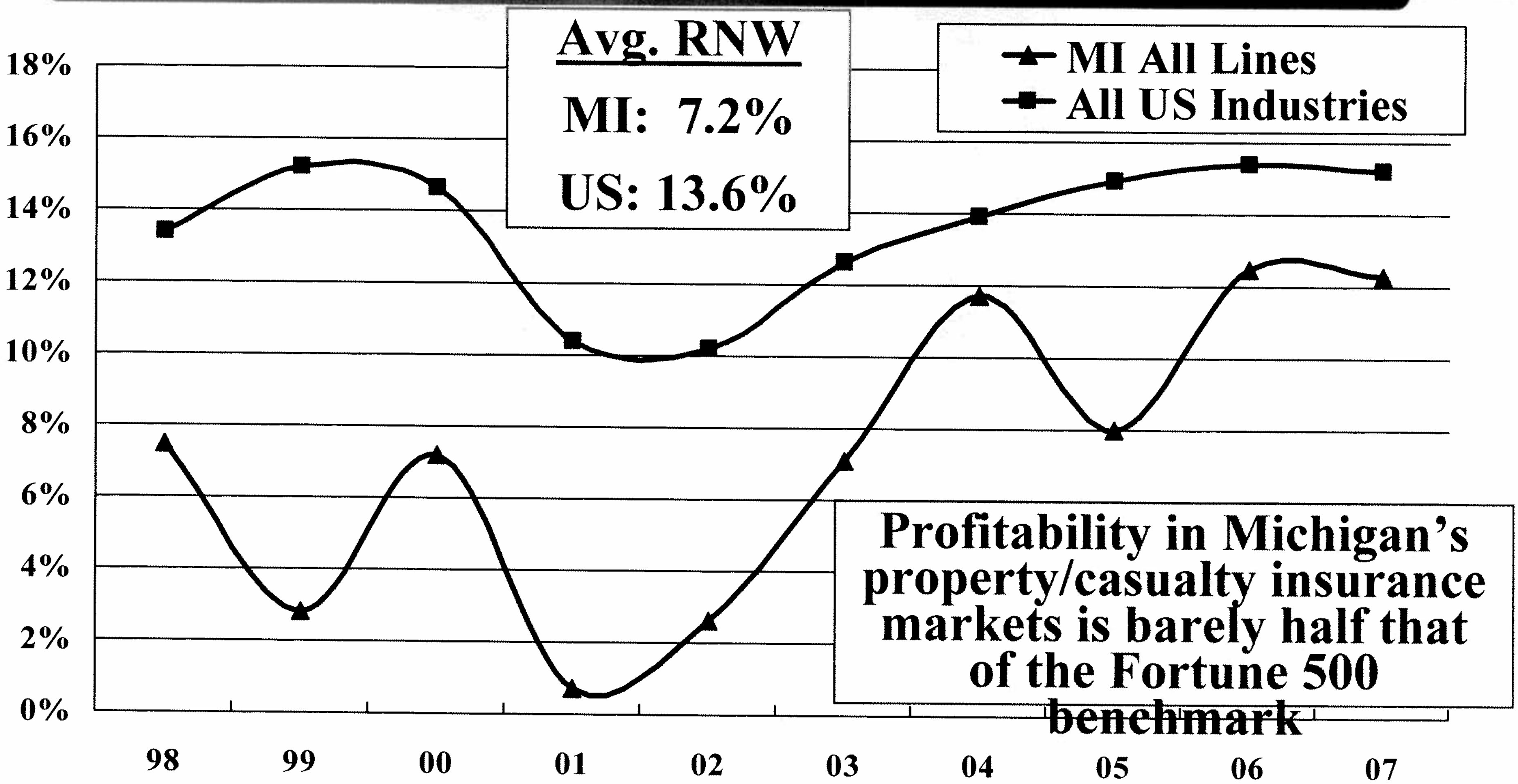
*RNW: All Lines Michigan vs. All Line US, 1998–2007**



*Latest available return on net worth (RNW) figure from the National Association of Insurance Commissioners is 2007.
Sources: NAIC, *Fortune;* Insurance Information Institute.

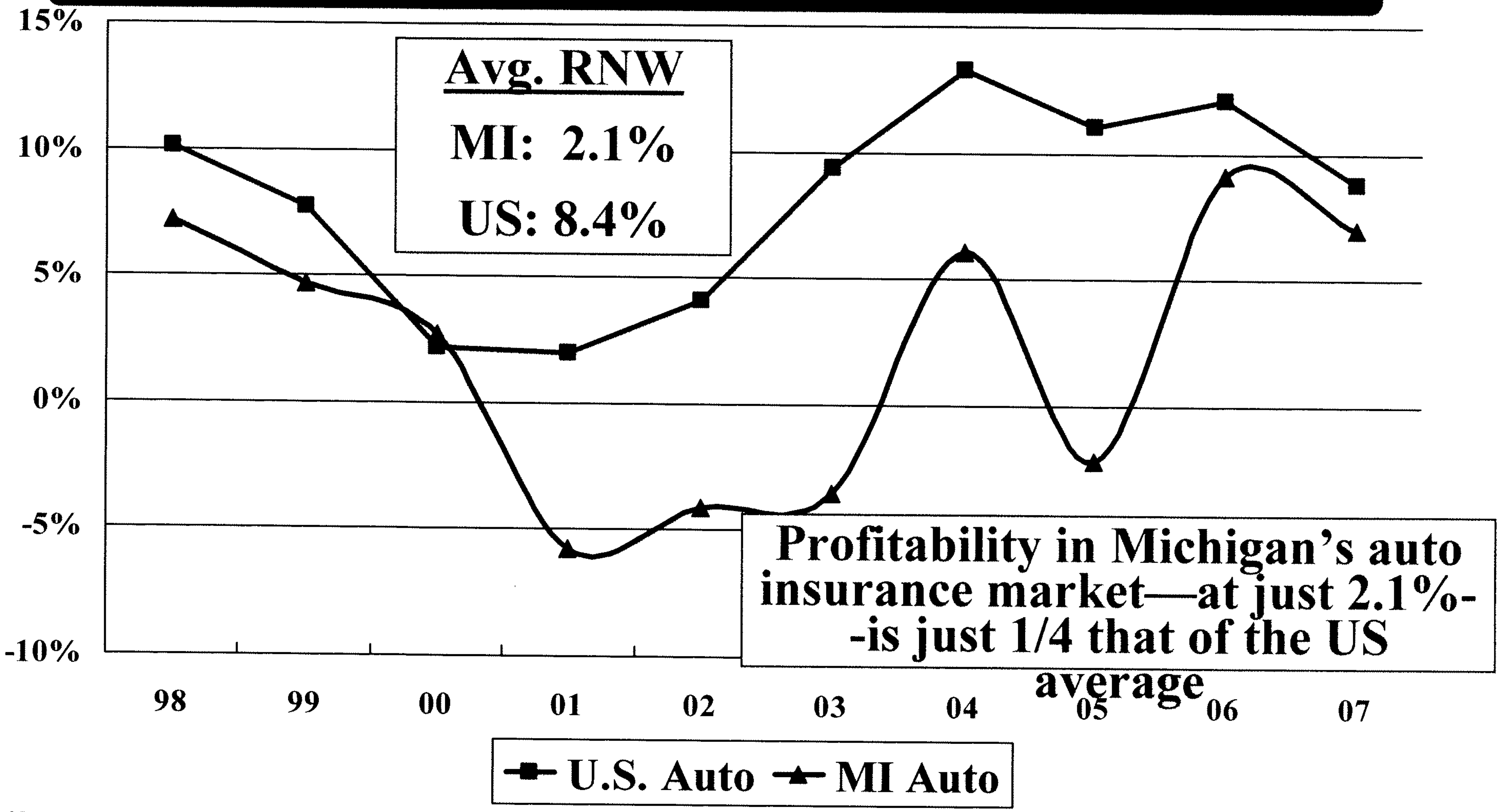
Figure 2.

RNW: Michigan All Lines vs. Fortune 500, 1998–2007*



*Latest available return on net worth (RNW) figure from the National Association of Insurance Commissioners is 2007.
Sources: NAIC, *Fortune;* Insurance Information Institute.

Figure 3. *RNW: Michigan Pvt. Pass. Auto vs. US Pvt. Pass. Auto, 1998-2007**

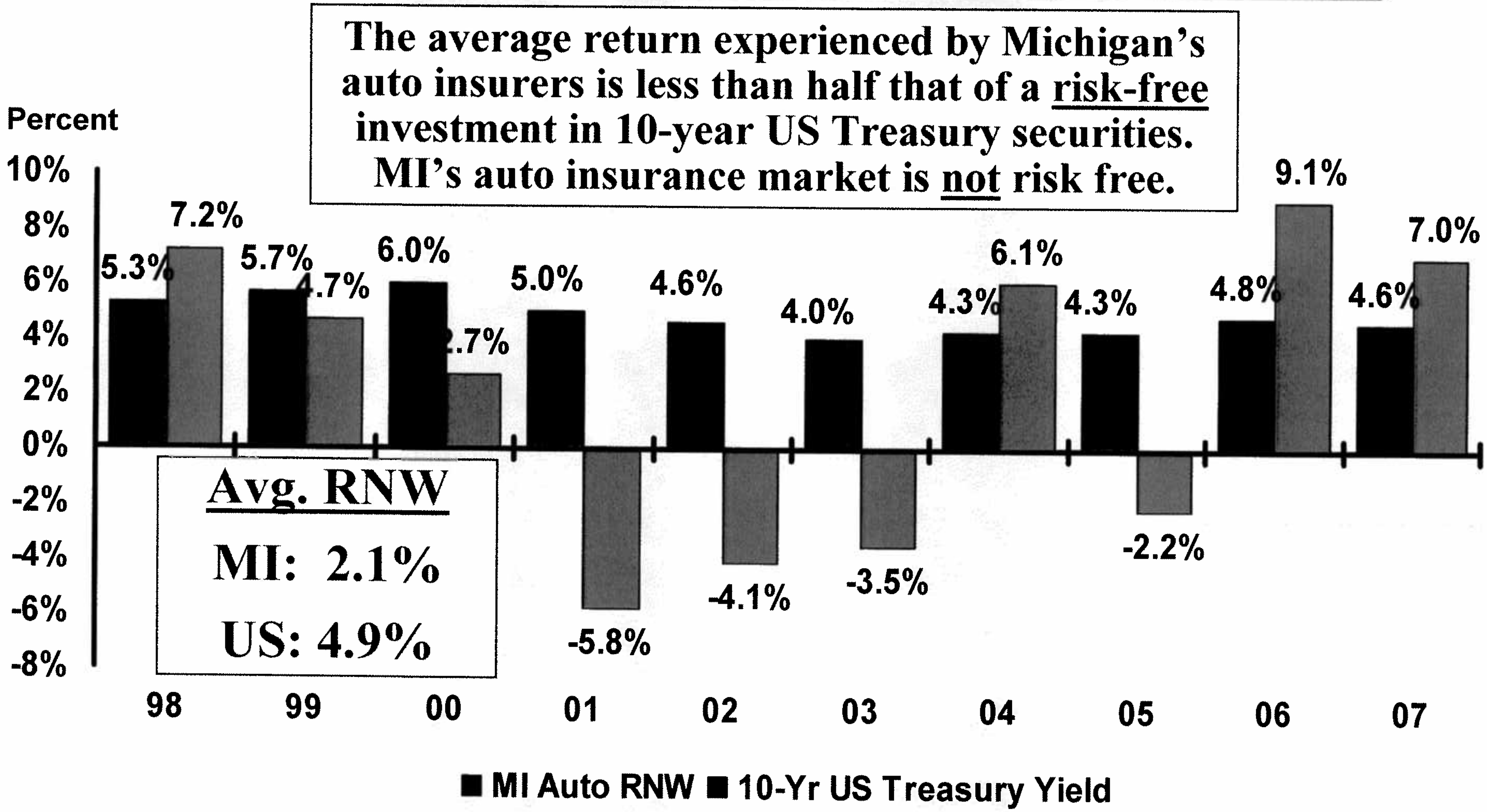


*Latest available return on net worth (RNW) figure from the National Association of Insurance Commissioners is 2007.

Sources: NAIC, *Fortune;* Insurance Information Institute.

Figure 4.

Michigan Auto RNW vs. 10-Year US Treasury Yield, 1998-2007*



*Latest available return on net worth (RNW) figure from the NAIC is 2007.
Sources: NAIC, Federal Reserve; Insurance Information Institute.

Figure 5.

*Average Auto Insurance Expenditure Michigan vs. US, 2000-2007**

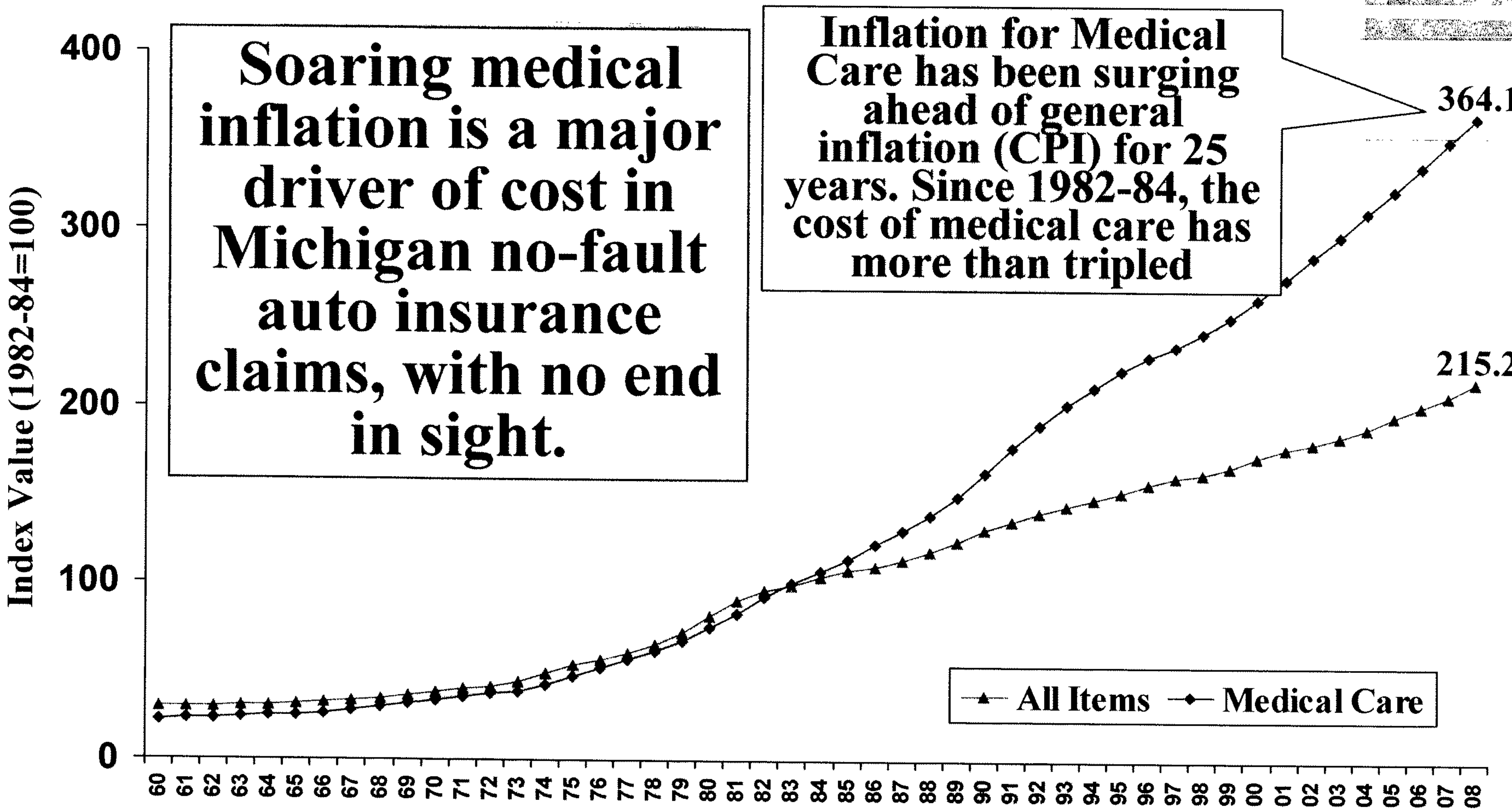
Year	MI	Rank	US
2000	$702	16	$690
2001	735	18	726
2002	887	14	786
2003	950	10	830
2004	980	10	842
2005	931	13	831
2006	925	13	816
2007	928	11	795

*Latest available data from the National Association of Insurance Commissioners is for 2007.
Sources: NAIC; Insurance Information Institute.

Figure 6.

Consumer Price Index for Medical Care vs. All Items, 1960-2008

(Base: 1982-84=100)



Source: Department of Labor (Bureau of Labor Statistics; Insurance Information Institute.